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African revival shifts east

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Africa has been one of the fastest-growing regions in the world. Since 2000, the frontier economies of Sub-Saharan Africa have grown at an annual average rate of 6.3%, a little faster than the larger emerging markets.

One popular view is that this early success will not last. It is simply a manifestation of the super cycle in commodities and strong demand from China in particular. There are good reasons for this.

The region is heavily dependent on natural resources and its fastest-growing economies have tended to be the more resource-intensive ones. Fuel, metals, minerals, and food account for 90% of exports from the region. Net commodity exports (i.e. exports less imports) are 23% of GDP.

The structure of most African economies has also changed relatively little. Agriculture still accounts for the bulk of employment, and manufacturing is no bigger share of output than it was 20-30 years ago. Poverty rates are falling but only slowly as the benefits of growth have accrued disproportionately to the elites. Sceptics argue that this does not bode well for the region given the transition to slower and less resource-intensive growth in China.

But it is not the full story. Better economic policies, stronger institutions, and more stable political environments have supported sustained economic booms even in countries that are not especially rich in natural resources.

Among the oil producers, support for reforms that proved elusive when revenues were booming may now be forthcoming. Last month’s election of Muhammadu Buhari in Nigeria on a strong anti-corruption platform could prove to be an opportunity in this regard. Lower oil revenues are intensifying the momentum to diversify the oil economies, particularly in Angola and Nigeria.

Most countries in Africa are energy importers and will benefit from lower oil prices. Many are also largely producers of soft commodities, which should be less sensitive to the slowdown in capital spending in China.

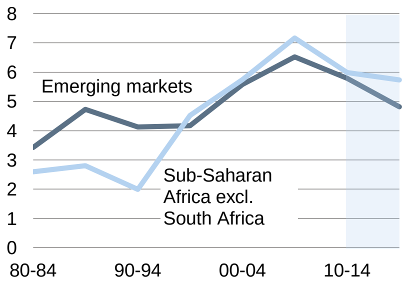
On balance, we think that the region’s centre of economic gravity will shift towards the less resource-intensive countries of east Africa, including Ethiopia, Kenya, Mozambique, Tanzania, and Uganda. They are economically more diverse and beginning to form a relatively large and well-integrated regional market. Investment flows, including from China, have already begun to shift in this direction.

These countries likely stand a better chance of delivering the structural transformation that will be needed to create jobs. This will be critical as half of the one billion new workers set to join the global labour force over the next twenty-five years will do so in frontier Africa.

African revival shifts east

Africa's revival 1

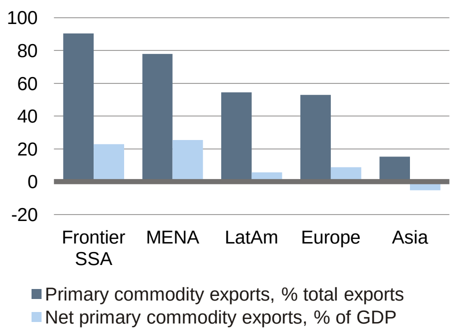
Real GDP growth, %



Sources: Haver Analytics, IMF World Economic Outlook, Deutsche Bank

Commodity dependence 2

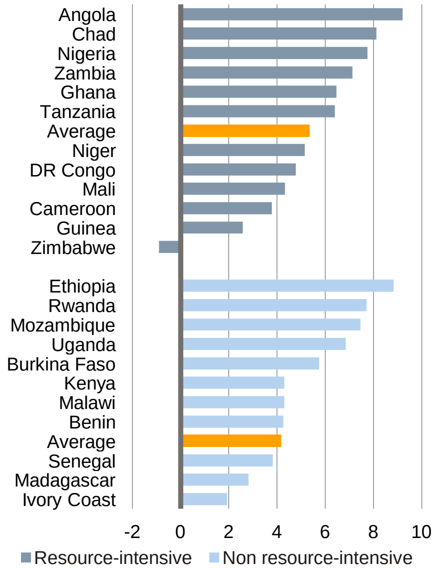
%



Sources: UNCTAD, IMF, Deutsche Bank

Commodity producers have enjoyed higher growth 3

Average annual real GDP growth, 2000-14 (%)



Resource intensive countries are defined here as those with natural resources account for more than 25% of total exports. The chart excludes countries with populations of less than 10 million. They are included in the (unweighted) averages for each group.

Sources: Haver Analytics, IMF, Deutsche Bank

Africa has for some time been one of the fastest-growing regions in the world. Since 2000, the frontier economies of Sub-Saharan Africa have grown at an annual average rate of 6.3%, a little faster than the larger emerging markets regularly covered in our reports.[1] This represents a dramatic turnaround from the economic malaise that characterized the region for much of the preceding two decades. The IMF, in its latest World Economic Outlook projections, expects this outperformance to continue in the next few years.

One popular view is that this revival is largely a reflection of the boom in commodity prices and, in particular, strong demand from China. There are good reasons for this. By almost any metric, frontier Africa is one of the most commodity-dependent regions in the world. Fuel, metals, minerals, and food account for 90% of exports from the region. Net commodity exports (i.e. exports less imports) are 23% of GDP, ranking alongside the oil-dominated economies of the Middle East and North Africa.

Exports to China have been growing at an annual average rate of 26%, double the rate of increase to other markets. A couple of years ago, China became the largest single export market for frontier Africa, surpassing the US. It now accounts for 18% of the region's exports, not far short of the 23% of exports going to all euro area countries combined.

Growth has been stronger in the more resource-intensive countries in the region, especially the oil producers (see chart below). Angola and Nigeria, the two largest economies in the region, have grown at average annual rates of 8-9% for the last decade and a half, making Nigeria comfortably the largest economy on the continent, including South Africa and North Africa.

Other countries have been hoping to join this club. Large discoveries of oil and gas reserves in Mozambique, Tanzania, and Uganda, have brought these countries to the cusp of becoming significant new producers of energy.[2] The investments needed to bring this about may be harder to sustain in an environment of lower prices.

Sceptics also point to what has not happened. The process of structural transformation has been slow. Agriculture still accounts for the bulk of employment, and the share of manufacturing in total economic activity remains much the same now as it was 20-30 years ago. Poverty rates are falling across the region but only slowly as the benefits of growth have accrued disproportionately to the elites, a phenomenon that has been especially pronounced among the region's oil producers.

As such, it could be argued that Africa's revival is built on flimsy foundations and will quickly dissipate as growth in China slows and the boom in commodity prices fades. Moreover, to the extent that recent growth has translated only slowly into improved living standards for much of the region's population, fragile support for economic reforms could disappear and turn to populism.

[1] We define frontier Africa in this report as the countries in Sub-Saharan excluding South Africa. We exclude South Africa from our assessment as it constitutes a more mature emerging market and is subject to somewhat different economic driving forces. Similarly, we exclude the economies of North Africa, which in many respects have more in common with the oil-producing countries of the Middle East.

[2] "Mozambique: A growth story which can be sustained". Schaffnit-Chatterjee. Deutsche Bank Research. July 2013. Frontier country reports: Mozambique. June 2014. Tanzania. October 2014. Uganda. August 2014. Deutsche Bank Research.

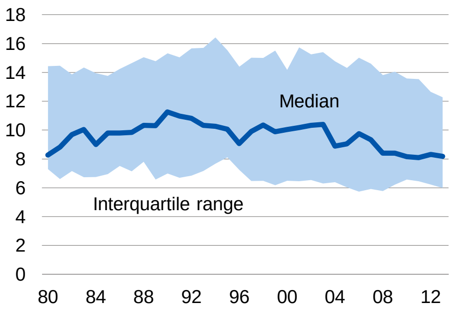
More than just commodities

However, the improvement in Africa's economic performance in recent years has always been about more than just commodities. Ethiopia, Rwanda, and Uganda, for example, are not especially rich in natural resources, but have nevertheless also enjoyed sustained economic booms. As we have argued elsewhere, this largely reflects better economic policies.[3]

Moreover, the region's dependence on commodities can easily be overstated. The aggregate figures are inflated by oil exports from Angola and Nigeria, which account for two-thirds of the region's non-renewable commodity exports. Many are also largely exporters of food, which should be less sensitive to the downside risks to commodity prices from the transition taking place in China from investment towards consumption-led growth.

Structural transformation has been slow 4

Manufacturing share of value added, %

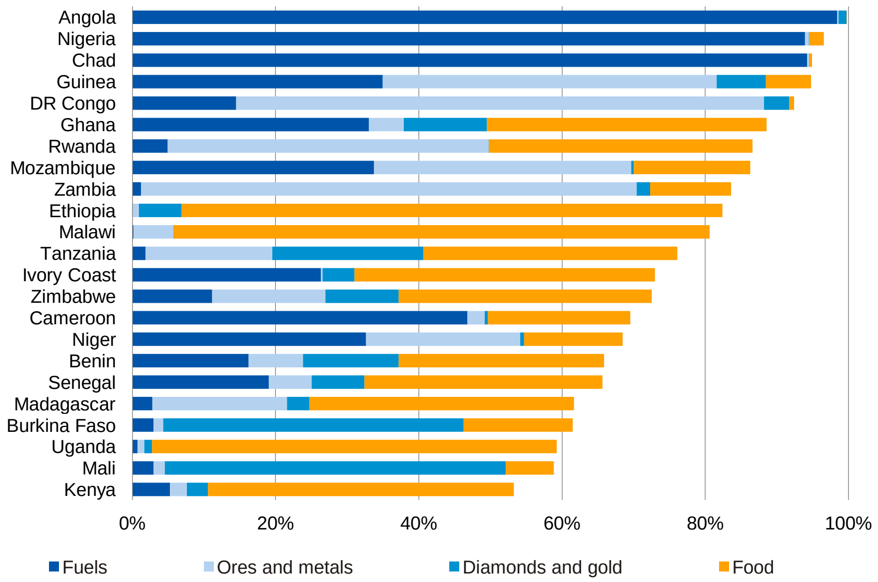


Estimates based on 27 countries for which data is readily available.

Sources: World Bank World Development Indicators, Deutsche Bank

Renewable and nonrenewable commodities 5

Primary commodities, % total exports

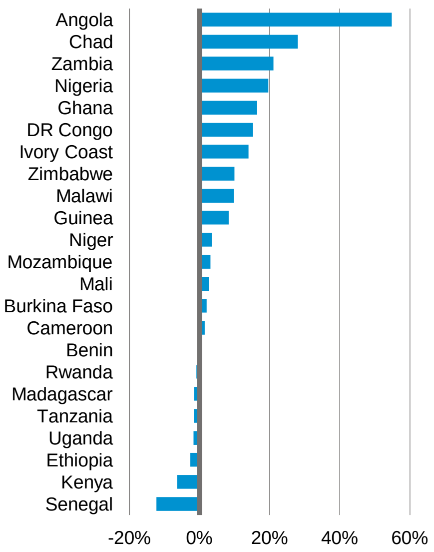


Countries ranked by dependence on nonrenewable natural resources (fuels, ores and metals, diamonds and gold); excluded countries with populations of less than 10 million.

Sources: UNCTAD, Deutsche Bank

Net commodity trade by country 6

Net commodity exports, % of GDP



Excludes countries with populations of less than 10 million.

Sources: UNCTAD, IMF, Deutsche Bank

At a country level, net exports of commodities account for over 10% of GDP in only around a dozen cases. In well over half of the countries in the region, however, net exports of commodities are less than 4% of GDP, and 18 countries are actually net importers of commodities.

As such, we would characterize the truly commodity-dependent countries within the region as follows:

— Six oil producers (Angola, Chad, Republic of Congo, Equatorial Guinea, Gabon, and Nigeria) where oil accounts for almost all exports. Net commodity exports are exceptionally high among this group at close to 50% of GDP on average.

[3] See, for example"Sub-Saharan Africa: A bright spot in spite of key challenges". Schaffnit-Chatterjee. Deutsche Bank Research. July 2013. "Ethiopia: The African tiger". Schaffnit-Chatterjee. Deutsche Bank Research. October 2013. "Africa's frontier markets: growing up". Burgess and Mühlberger. Deutsche Bank. November 2011.

— Two other economies, Botswana and Zambia, that are also heavily reliant on a single commodity – copper in Zambia and diamonds in Botswana.

— Half a dozen other major commodity producers that export a relatively broad mix of products (Democratic Republic of Congo, Guinea, Ghana, Ivory Coast, Namibia, and Zimbabwe)

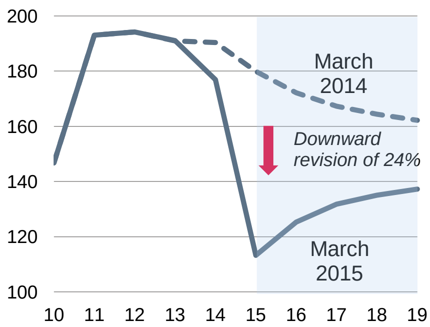
Leaders and laggards

Energy exporters

Not all commodities are equal, of course, and it is the outlook for oil and other energy prices that has been marked down the most over the last several months. Below, for example, we show the IMF forecast for energy prices. Last year, the Fund was already anticipating a modest decline in prices. But it has since substantially pared its forecasts further.

Energy prices now expected to be much weaker 7

Energy prices (2005=100)



Sources: IMF, Deutsche Bank

This is not good news for the region's oil producers, which lack the large sovereign wealth funds and foreign reserves of the Middle East producers and thus face more significant challenges in adjusting to lower prices.

— In Nigeria, lower oil prices will likely result in a (slightly) negative current account balance for the first time in over a decade. Despite three downward revisions to budget oil price, from USD 78 to USD 52 per barrel, the fiscal deficit is set to widen to close to 4% of GDP this year. The naira has lost 20% of its value since mid-2014, foreign reserves have fallen to less than 5 months of import cover, and the Central Bank of Nigeria has hiked its policy rate by 100 bps to 13%.

— In Angola, the government responded more swiftly, halving the budget oil price for this year to USD 40 per barrel, with significant cuts in public spending, including to fuel subsidies and various investment projects.[4] The current and fiscal accounts are nevertheless still likely to swing into significant deficits this year, to around 5-6% of GDP. The kwanza has depreciated by 10% and remains under pressure. The central bank has increased its policy rate by 50 bps since October to 9.25% and further hikes are likely to follow. On the positive side, Angola has substantial foreign reserves which, though falling, are expected to remain above USD 20 bn or 6 months of import cover.

— Ghana is much less reliant on oil than Angola and Nigeria but was already struggling with large fiscal and current account deficits, which were each close to 10% of GDP last year.[5] Government debt has risen to 68% of GDP, making it the most indebted of any large frontier African economy. This is only partly due to the falling price of gold, oil and, to a lesser extent, cocoa. At least as important has been poor fiscal discipline, particularly a surging wage bill and other excessive spending in the run up to the 2012 elections. After a brief surge in August and September in anticipation of a new IMF program, the cedi has resumed its long downward trend.

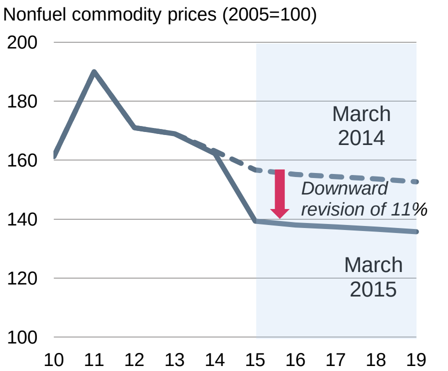
This is not to say that the region's oil producers are likely to fail. Lower oil revenues should sharpen incentives to diversify their economies. In Nigeria, last month's election of Muhammadu Buhari on a strong anti-corruption platform, the first time an incumbent president has been unseated at the ballot box, provides an historic opportunity to press ahead with such reforms. Whether Buhari will be able to deliver is not a given. Ghana, for example, also enjoys a vibrant

[4] Frontier country report: Angola. December 2014. Deutsche Bank Research.
[5] Frontier country report: Ghana. March 2015. Deutsche Bank Research.

democracy and the smooth transition of power is now the norm. But this has not obviously led to better policy outcomes, as a result of which Ghana has spent much of the last 20-30 years under successive IMF programs.

Energy importers

More modest revisions to non-fuel commodity prices 8



Sources: IMF, Deutsche Bank

Most of the countries in frontier Africa import more energy than they export. These countries will benefit from reduced inflationary, fiscal and external pressures and could see their fiscal and current account balances improve by a couple percentage points of GDP on the back of lower oil prices.

The outlook for other commodity prices has also weakened but to a lesser extent. The IMF had been expecting a very gradual deceleration in nonfuel commodity prices over the medium term. Over the last year, the Fund has revised these forecasts down by about 11%, but by slightly more for metals and bulk commodities, especially iron ore.

Based on the commodity composition of trade outlined above, we can assess how the terms of trade for the region will evolve in response to these expected relative movements in commodity prices. Not surprisingly, it is the energy exporters, and in particular the six large oil producers noted above, that face the biggest deteriorations in their terms of trade.

More of the energy importers see an improvement in their terms of trade, as the cheaper cost of energy imports will offset lower prices for their commodity exports, although not uniformly. Countries with only relatively modest net energy imports but significant net exports of metals, for example, such as Mozambique, Rwanda, and Zambia, are also set to see their terms of trade weaken. The biggest winners are those countries with either large energy import needs or relatively fewer commodity exports, such as Kenya and Tanzania, and to a lesser extent Ethiopia and Mozambique.

Look east

Africa's centre of economic gravity is thus likely to shift from west to east, to the less commodity-dependent economies of Ethiopia, Kenya, Mozambique, Tanzania, and Uganda. They enjoy a number of advantages, which we think should make this group the fastest-growing in frontier Africa over the next 5-10 years:

— They are relatively large, comprising over 250 million people, with a combined GDP of a little over USD 200 bn, and are (mostly) politically stable.

— They are economically more diverse than their neighbours to the west. In Kenya, for example, agriculture, industry, and services, account for 30%, 20%, and 50% of GDP, respectively. Moreover, each sector has been growing solidly (6% or above on average) in recent years.[6]

— They are also relatively well-integrated as a region. Kenya, Tanzania, and Uganda, together with Burundi and Rwanda, form the East African Community. These countries have already established a common market and are working towards establishing a monetary union.

Foreign investors have already recognized the opportunities. Mozambique, for example, is the largest recipient of direct investment in frontier Africa, attracting around USD 5 bn annually over the last 3-4 years (30% of GDP). Others have

[6] Frontier country report: Kenya. April 2015. Deutsche Bank Research.

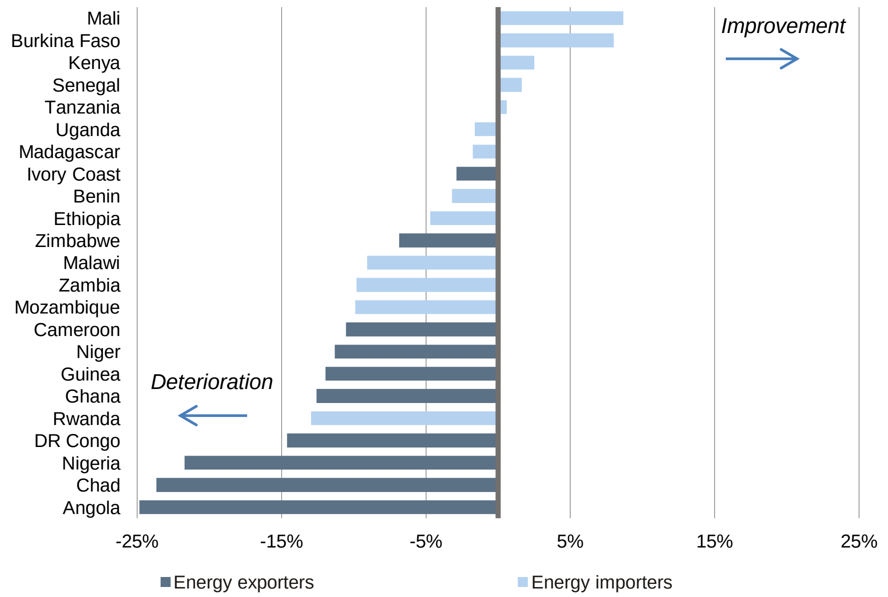
also seen a surge in investment. Chinese direct investment in Ethiopia, for example, reached USD 1 bn last year.

A lot of this investment has gone into infrastructure projects and newly emerging oil and gas sectors in the region. As noted above, we have yet to see a manufacturing revolution in Africa. What little foreign investment in manufacturing there was in the region was typically to exploit large price premiums in local markets rather than as a base for exports.

But there are some signs that this is changing. It was competition from low-cost Chinese producers that more or less wiped out the textile and clothing industries in Nigeria and South Africa. Rapidly rising wages for unskilled workers in China, however, are now prompting some of these producers to look for lower-cost places to do business to maintain the competitiveness of their global production networks.

Terms of trade: Leaders and laggards 9

Projected change in terms of trade (2015-19 relative to 2012-14)

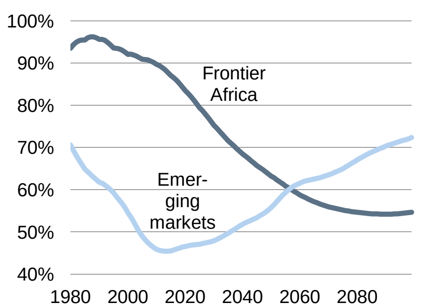


Excludes countries with populations of less than 10 million.

Source: Deutsche Bank

Africa's declining dependency ratio 10

Dependency ratio *



* Ratio of young (0-14) and old (65+) persons to the population of working age (15-64).

Sources: United Nations World Population Prospects, Deutsche Bank

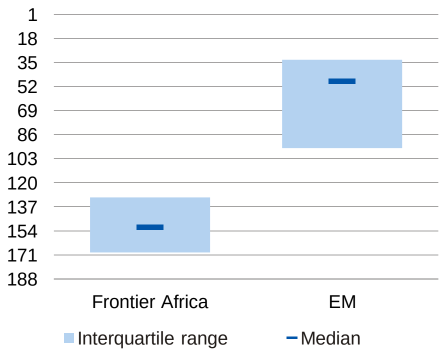
East Africa is well placed to attract this investment and indeed is starting to do so. China's new Silk Road Fund is an acknowledgement of this. It seeks to facilitate trade links with a number of frontier and emerging markets through a USD 40 bn infrastructure investment fund. In Africa, the fund is targeting the economies along the eastern seaboard, which suggests a shift away from China's traditional focus on securing natural resources towards one more focused on exploring the opportunities for establishing a manufacturing hub in the region.

Challenges and opportunities

Which African economies will take advantage of these opportunities, or best deal with the challenges presented by lower commodity prices, will ultimately come down to the quality of economic policy making in each case.

Ease of doing business: Room for improvement 11

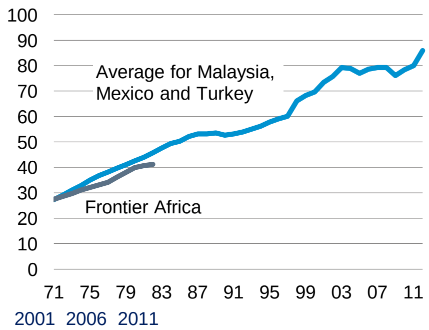
Doing Business ranking (1= best; 189=worst)



Source: World Bank Doing Business Indicators 2015, Deutsche Bank

Schooling rates similar to some EMs in late 1970s 12

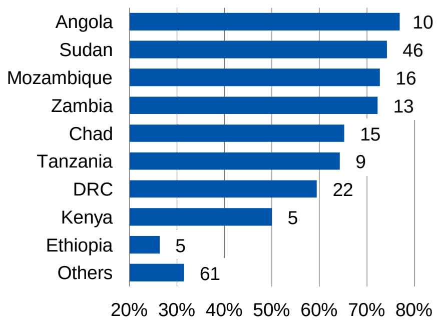
Secondary school enrollment rates, %



Sources: World Bank World Development Indicators, Deutsche Bank

Untapped agricultural potential 13

Uncultivated arable land, % total available for cultivation



Figures at the end of the bars show the absolute amounts of uncultivated land (millions hectares).

Sources: World Bank, Deutsche Bank

This is equally true of the demographic opportunity facing the region. Declining fertility and child mortality rates mean that working-age adults have become the fastest-growing segment of the population. The dependency ratio, that is the ratio of the non-working age population to the working age population, which is comfortably the highest of any region in the world, is set to continue falling sharply for the next several decades. Emerging markets have been through a similar process but their dependency ratios are now bottoming and will soon start rising as their populations begin to age.

Half of the increase in the global labour force over the next twenty-five years is set to come from frontier Africa. Whether this proves to be a blessing or a curse will depend on whether these 500 million potential new workers can be fully employed in productive activities. This means creating jobs and this in turn gets back to the issue of structural transformation.

The experience in other regions has been mixed but suggests that commodity producers have not fared as well in creating employment opportunities for rapidly growing young populations. This was most obvious in the Middle East and North Africa, where high youth unemployment was a factor in the political and social instability of the Arab Spring. It contrasts with the experience in East Asian countries, which were able to turn their youth bulges into demographic dividends.

While this again might tend to favour East Africa (over West Africa), productively absorbing an increase in the labour force of this scale will still require significant efforts in a number of areas, including:

— Closing the infrastructure gap. As noted above, there has been significant investment in infrastructure in recent years, much of it from China, but the region still lags behind other developing regions in almost all measures of infrastructure coverage. Access to water, road transport and electricity are particularly limited. Only 16% of roads are paved in the region, compared with 58% in South Asia. Only around a quarter of the population has access to electricity.

— Reducing the costs of doing business. The payoff to “hard” investments in infrastructure is greatly reduced if they do not go hand in hand with “soft” improvements in institutions and regulations. Complex and opaque regulations can significantly reduce the efficiency and raise the cost of doing business. Frontier African countries still score poorly on these metrics. According to the World Bank’s latest Doing Business indicators, the median frontier African country ranks 151st out of 189, compared with the median emerging market rank of 48th. Things are improving from this low base, however, as the region undertook the largest number of regulatory reforms making it easier to do business, accounting for around one-third of the worldwide total of such reforms last year.

— Improving human capital. By most metrics, the countries in frontier Africa still have the lowest levels of human capital in the world, although there has been some catch up over the last decade. Moreover, they may already be reaching levels where structural transition is becoming viable. Secondary school enrollment rates, for example, are already over 40% on average. This is similar to Malaysia, Mexico, and Turkey in the late-1970s, by which point their industrial transformation had already begun.

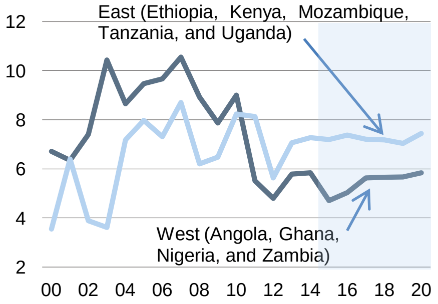
Finally, while the typical stylized path of economic development involves moving from a high share of employment in agriculture towards an increasing share of employment in manufacturing first and then gradually to services, this does not mean that the region’s comparative advantages in natural resources should be ignored.

On the contrary, we think agricultural production can continue to drive growth. Africa accounts for half of the world's uncultivated land that is suitable for growing food crops. And there is huge scope to increase yields given extremely low use of fertilizers and irrigation. Moreover, demand is increasing fast, both globally and in Africa itself, especially in cities, as rural to urban migration continues.[7]

Conclusions

Shifting east 14

Real GDP growth, %



Sources: IMF World Economic Outlook, Deutsche Bank

There are good reasons to think that the revival in African growth over the last decade has been based on much more than the super cycle in commodities and demand from China. Over the next decade, however, the region's centre of economic gravity is likely to shift towards the less resource-dependent economies in East Africa. Beyond the likely improvement in their terms of trade, they appear better-placed to deliver the structural economic transformation that will be needed if large increases in the working age population are to prove a blessing rather than a curse.

Nothing is guaranteed, however, and it will ultimately be the quality of economic policy-making that determines which countries are able to take advantage of this opportunity. The same is equally true of the economies in West Africa, which will face significant adjustment challenges in the near term, but may find it easier to generate support for difficult structural reforms that proved elusive when natural resource revenues were booming.

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7 See "Agricultural value chains in Sub-Saharan Africa: from a development challenge to a business opportunity". Schaffnit-Chatterjee. Deutsche Bank Research. April 2014.

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